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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268–0001

ANNUAL COMPLIANCE REVIEW, 2014	Docket No. ACR2014

REPLY COMMENTS OF THE UNITED STATES POSTAL SERVICE
(February 17, 2015)

In Order No. 2313, the Postal Regulatory Commission solicited comments on the United States Postal Service's Annual Compliance Report (ACR) for Fiscal Year 2014.[1] On February 2, 2015 (or before), the Public Representative and 16 private parties filed comments.[2] The Postal Service hereby submits its reply comments.

I. Scope of ACR Proceeding

As in past ACR dockets, it has become necessary to reiterate the scope of the instant proceeding under the Postal Accountability and Enhancement Act (PAEA). Section 3653 of title 39 directs the Commission to do four things in this docket, two of which relate to compliance and two of which do not. As to compliance, the Commission is charged with determining: (1) whether any rates or fees in effect during the preceding year were not in compliance with chapter 36 and its accompanying regulations; and (2)

[1] Order No. 2313, Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments, Docket No. ACR2014 (Dec. 31, 2014); United States Postal Service FY 2014 Annual Compliance Report, Docket No. ACR2013 (Dec. 29, 2014) ("ACR").
[2] Beyond the Public Representative, parties filing comments on February 2, 2015, included PHI, PostComm, Utah Hispanic Chamber of Commerce, Stamps.com, American Catalog Mailers Association (ACMA), National Postal Policy Council (NPPC), Valpak, UPS, Pitney Bowes (PB), Greeting Card Association (GCA), Progressive Direct Mail Advertising, APWU, Citizens Against Government Waste, and National Taxpayers Union. The Taxpayers Protection Alliance filed on January 30, 2015, and Douglas F. Carlson filed what were labeled as Comments on January 16, 2015.

whether any service standards in effect during the preceding year were not met.[3] Separate from these compliance determinations, the Commission: (3) is directed to review whether the Postal Service has met its performance goals; and (4) may advise the Postal Service as to the protection or promotion of the public policy objectives of title 39.[4] While fewer comments fall outside the scope of the ACR this year than in years past, the tendency remains.

It may also be useful to reiterate that wide scope of comments submitted precludes response to each and every assertion made by the parties. The mere fact that the Postal Service in these reply comments does not address a claim, argument, or opinion expressed in an initial comment should not be construed to suggest that the Postal Service agrees with that claim, argument, or opinion.

II. Pricing

A. NPPC's Presort First-Class Mail cost coverage grievance lacks substance.

The National Postal Policy Council (NPPC) references successive Annual Compliance Determinations and compares the respective cost coverages for Presort and Single-Piece First-Class Mail, and the Presort cost coverage to the system average. On this basis, NPPC argues that the current prices paid by Presort First-Class Mail are neither "just" nor "reasonable," within the meaning of section 3622(b)(8). NPPC Comments at 2-4. NPPC's grievance is devoid of any reference to the actual prices Presort pays relative to Single-Piece First-Class Mail, or to the relative unit contributions of the two products. NPPC does not acknowledge the logical result that

[3] 39 U.S.C. § 3653(b).
[4] 39 U.S.C. § 3653(d).

Single-Piece should have a lower unit contribution than Presort, as the former product carries with it certain costs – e.g., associated with lower-quality addressing and first-mile collection – that are not related to worksharing and that do not pertain to Presort. NPPC dismissively summarizes the Postal Service's pricing decisions and the Commission's annual review of those decisions as a process that has perpetuated "systematic, consistent and persistent discrimination" against Presort First-Class Mail. *Id*. at 4.

The Commission has rejected similar lamentations by Presort First-Class Mail advocates in past Annual Compliance Determination dockets. In the end, mailers pay prices. Under section 3653(b)(1), a critical question currently before the Commission is whether any rates in effect during fiscal year 2014 for any products failed to comply with applicable provisions of chapter 36 of title 39 United States Code. The question is not simply whether a different mix of compliant prices could be established. The Commission has (1) reiterated that the Consumer Price Index cap in section 3622(d)(1)(A) works to shield market dominant products -- including Presort First-Class Mail -- from excessive price increases and (2) has noted the Postal Service's use of pricing flexibility to benefit Presort, for instance, by substantially reducing additional-ounce prices. Annual Compliance Determination (ACD) for Fiscal Year 2012, at 82 (March 28, 2013). At page 6 of its comments in the instant docket, NPPC dismissively gripes that its members have received "little of the pricing flexibility" cited by the Commission. Aside from expressing a strong preference for paying lower prices at every turn, NPPC offers no prescription for what would constitute a more just or reasonable use of such flexibility.

B. Metered First-Class Mail pricing

1. The GCA price discrimination claim rings hollow.

The Greeting Card Association (GCA) argues that the existence of the Single Piece Metered First-Class Mail price category constitutes “discrimination” against household mailers and raises the question of whether such discrimination is “just and reasonable” within the meaning of section 3622(b)(8). GCA Initial Comments at 4-5. GCA’s discussion of price discrimination avoids acknowledging the critical limitation that discrimination in postal pricing is problematic only if found to be either “undue or unreasonable” within the meaning of section 403(c). A reasonable basis existed for establishment of the meter price category and justifies its continuation. It is insufficient to allege that the mere existence of a price differential renders the rate schedule unjust and unreasonable within the meaning of section 3622(b)(8). At pages 4-5 of its Initial Comments, GCA characterizes this metered/stamp price differential as pitting the interests of First-Class Mail business mailers vs. household mailers. GCA Initial Comments at 4-5. This sweeping generalization contradicts GCA’s concession that “computer-using households could” use PC postage to reap the benefit of the metered mail price. GCA Initial Comments at 2, fn. 3. By implication, it also ignores the undisputed fact that numerous businesses and non-household entities, especially smaller ones, continue to prefer stamps as their principal method of paying First-Class Mail postage for a variety of reasons. The fact that a price category may *primarily* benefit either businesses or households does not make it *per se* “unduly discriminatory” under 403(c) or “unjust or unreasonable” within the meaning of section 3622(b)(8).

At page 5 of its Initial Comments, GCA argues that if users of the meter rate are "small" relative to single-piece First-Class Mail users as a whole who -- for whatever reason -- do not make use of it, then the meter rate is unjust and unreasonable within the meaning of section 3622(b)(8). Thus, according to GCA, failure to attract an unspecified (non-small) percentage of volume from the baseline product makes a new price category unjust and unreasonable. Application of GCA's statutory interpretation could eliminate a large number of price differentials in the Mail Classification Schedule. However, there is no basis for concluding that GCA's test should stand as the basis for assessing compliance with section 3622(b)(8).

After review of several fiscal quarters of nascent RPW and billing determinant data for the metered mail price category, GCA expresses concern that the size of the market for the category is uncertain and that it is possible that the differential is ineffective in attracting or retaining mail volume. *Id*. at 5-6. Pitney Bowes offer a more positive perspective on the data that GCA attempts to downplay. *See* Comments of Pitney Bowes Inc. at 4. GCA offers no support for the speculation at page 6 of its Initial Comments that all single-piece stamped First-Class Mail that would have converted to meters already has done so. GCA's speculation is refuted by the responses to Questions 2 and 3 of the survey presented as part of the Initial Comments of Stamps.com.

GCA is silent regarding whether the overall volume declines across First-Class Mail obscure the possibility that availability of the Single Piece Metered First-Class Mail price category differential may slow the diversion of metered volume from the mailstream. In contrast, the Initial Comments of Stamps.com shed light on the reaction of single-piece First-Class Mail PC postage users who began using Stamps.com after the meter rate was introduced. Over a quarter of Stamps.com survey respondents reported (in response to Question 4) that availability of the metered mail differential encouraged them to mail more pieces than they might have in it absence. It should come as no surprise that a modest price differential that requires users to change long-standing mailing practices may not have instant universal or widespread appeal. The absence of such appeal for a nascent price category does not, by itself, support the conclusion that the price differential is unjust or unreasonable within the meaning of section 3622(b)(8).

2. The GCA efficiency claim is based on a misreading of the record.

GCA argues that the available three fiscal quarters of data provide no empirical basis for concluding whether the Single-Piece Metered First-Class Mail price category "maximize[s] incentives to reduce costs and increase efficiency," within the meaning of section 3622(b)(1). *Id*. at 7-8. GCA references "operational benefits the Postal Service foresaw" in establishing the metered price category in Docket No. R2013-10 and then argues that there is no evidence of a projected reduction in FY 2014 mail processing costs that was supposedly expected by the Postal Service. *Id*. A cursory reading of the actual metered price proposal makes clear that GCA has misstated the nature of the benefits that the Postal Service expected to result from introduction of the new price category. Contrary to the implications in GCA's Comments, the Postal Service did not project any *mail processing* efficiency gains. The benefits are expected to materialize in the areas of stamp production and retail operations for the Postal Service, and in the efficient and secure management of postage for meter users. *See* Docket No. R2013-10, United States Postal Service Notice of Market Dominant Price Adjustment, at 20

(September 26, 2013); and Response of the United States Postal Service to Chairman's Information Request No. 6, Question 2 (September 29, 2013).

C. The Public Representative's suggested method to adjust passthroughs should be ignored.

The Public Representative calls into question several of the Postal Service's reported workshare discounts, and recommends a method by which the Postal Service could reduce the number of passthroughs that are above 100 percent. The Commission should ignore this recommendation. As explained in the Postal Service's initial filing in this docket, the timing of the Postal Service's price change filings and the filing of the ACR does result in a number of workshare passthroughs that exceed 100 percent, caused by changes in cost avoidance estimates. The Public Representative suggests that a way to reduce the impact of these cost avoidance changes would be to simply reduce all workshare discounts across the board, and thereby reduce the number of passthroughs above 100 percent.

While this mathematical exercise would indeed result in fewer passthroughs above 100 percent, the Postal Service does not believe it is appropriate to adjust any of its workshare discounts in this proceeding. Moreover, as the Public Representative concedes, the Postal Service has already mitigated these passthroughs by its most recent price change filing in Docket No. R2015-4. The Postal Service will continue to monitor the cost avoidance estimates and passthroughs for all of its market dominant products, and will consider additional adjustments in its future pricing proposals based on the latest cost avoidance estimates available at the time of filing. There is no compelling justification to make any adjustments to the workshare discounts as part of the instant proceeding. The Postal Service's workshare discounts and passthroughs remain consistent with section 3622(e).

D. NPPC's price cap prescription conflicts with the statute.

The National Postal Policy Council urges the Commission to consider adjusting the price cap for First-Class Mail to offset increased mailer costs, related to mailer responses to service reductions, and to other costs that the Postal Service has shifted onto customers. NPPC argues that the Commission should reduce the price cap to reflect mailer costs related to (1) earlier mail entry deadlines resulting from the Network Rationalization service standard changes, (2) conversion of barcodes from POSTNET to Basic Intelligent Mail barcode (IMb), and then to Full-Service IMb, and (3) software updating to reflect changes in Postal Service systems. NPPC Comments at 11-14.

However, the price cap limits only "the percentage change in rates," as determined by the "change in the Consumer Price Index." 39 U.S.C. § 3622(d)(1)(A). Mailer costs are not part of the change in rates or the Consumer Price Index, and therefore cannot be considered by the Commission, absent legislative change. The Commission recognized the need for legislative change to incorporate service changes in the price cap, in its Section 701 report reviewing the PAEA in 2011. There, the Commission recommended that Congress consider allowing extra rate adjustment authority should the Postal Service enhance service, but asserted that any such change should apply only to service enhancements, rather than to service reductions. Section 701 Report, at 40 (September 22, 2011).

Otherwise, the Commission has previously rejected suggestions to incorporate changes in service level or mailer costs into the price cap. See Order No. 26, at 32-33 (August 15, 2007); Order No. 43, at 31-32 (October 29, 2007). The Commission noted the lack of a method for incorporating such adjustments into the price cap, and that issue remains.

Moreover, NPPC focuses on the Network Rationalization Phase 2 service standard change that applies the First-Class Mail overnight service standard only to Presort entered before noon or 8:00 a.m. on Day Zero. However, that change was not implemented until January 5, 2015, more than three months after the conclusion of fiscal year 2014.[5] Accordingly, the nexus between the instant review of FY 2014 prices and the FY 2015 service standard change that gives a considerable preference to Presort First-Class Mail is not self-evident to the Postal Service.

E. Valpak's criticisms of Market Dominant NSAs are unwarranted

In Part VI of its comments on the 2014 ACR, Valpak alleged that the net value estimation methodology employed by the Postal Service fails to satisfy the section 3622(c)(10) requirement that an NSA improve the Postal Service's net financial position by reducing cost or increasing overall contribution. Valpak then urged the Commission to find that the recently expired Discover NSA violated section 3622(c)(10) and to exercise its authority to remedy the alleged ill effects of the alleged noncompliance. Although Valpak fulminates about the expired Discover NSA, its principal objections seem to be about the pending Discover NSA. It specifically called for the Commission to reject the new Discover NSA currently pending or to approve it only if it "results in net

[5] *See* 79 *Federal Register* 44700 (August 1, 2014).

additional contribution over and above the [$25,350,000 in allegedly] lost contribution from the recently ended Discover NSA". Valpak also called for the Commission to issue corresponding non-compliance findings and to "determine an appropriate remedy".

Statutorily, an NSA must "*either* improve the net financial position of the Postal Service through reducing Postal Service costs or increasing the overall contribution to the institutional costs of the Postal Service; *or* enhance the performance of mail preparation, processing, transportation, or other functions" [emphasis added]. Contrary to Valpak's assertions regarding contribution, the Postal Service has demonstrated that the NSAs "improve [its] net financial position". As the Public Representative noted, First Class Mail had "strong cost coverage"[6] and Standard Mail's cost coverage increased by seven percent (7 percent) resulting in $16.1 billion and $7.0 billion respectively.[7] NSAs such as Discover and PHI contributed to these results.

As Harit Talwar[8] indicated in his statement in Docket No. R2015-2, "Discover's mail spend has grown dramatically in past years, in no small thanks to [the] previous NSA".[9] Furthermore, "[a]s shown in USPS-FY14-30, the net benefit of the Discover NSA for the contract year of April 2013 to March 2014 is estimated to be between $18.2 million and $23.1 million".[10] Thus, "the Discover NSA improved the net financial position of the Postal Service".[11]

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[6] Public Representative Comments, Annual Compliance Review 2014, Docket No. ACR2014 (Feb. 2, 2015) at 27.
[7] Id. at 28-29.
[8] Mr. Talwar is Discover Financial Service's Executive Vice President, President—U.S. Cards, and Chief Marketing Officer.
[9] Statement of Harit Talwar, Discover Financial Service Executive Vice President, President—U.S. Cards, And Chief Marketing Officer, Docket Nos. MC2015-3, R2015-2 (Oct. 28, 2014) at 4; [Hereafter, "Talwar Statement"]. *See also*, Comments of Discover Financial Services, Docket Nos. MC2015-3, R2015-2 (Nov. 17, 2014) at 3; [Hereafter, "DFS Comments"].
[10] Id.
[11] Id.

There is no statutory requirement which mandates the use of any one methodology. In this regard, the Postal Service should have the flexibility to determine and employ relevant and appropriate methodologies compatible with its business model. In Docket No. R2015-2, with regard to the NSA pending review, Discover noted the following:

> DFS-LR-1 analyze[d] the volume growth incentive provided by the NSA, implied elasticity, and net value to the Postal Service under a variety of Before-Rates volume scenarios. . . [Discover believes] the NSA improves the Postal Service's financial position even if Before-Rates volumes exceed (1) the Postal Service's forecast of 1.03 billion pieces by more than 150 million pieces, and (2) Discover's FY 2014 volumes of 1.125 billion pieces by 60 million pieces. Further, all implied elasticities for these scenarios have absolute values of less than one with many being smaller than those in the Commission's accepted methodology.[12]

Valpak also criticizes the recent NSA concluded with PHI Acquisitions. Since the Potpourri NSA was implemented in Q4 of FY 2014, it generated "after-rebate revenue of $15.8 million, and attributable costs of $11.2 million, resulting in attributable cost coverage of 141 percent".[13]

Valpak correctly states that USPS-FY 14-30 reported a $128,090 reduction in contribution using Valpak's preferred methodology. However, it failed to consider the application of that methodology in Docket No. R2014-6. Consistent with its application therein, PHI believes the "result in contract year 1, Quarter 1 is $281,025 positive contribution as opposed to the loss of $128,090".[14]

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[12] DFS Comments at 13.
[13] United States Postal Service FY 2014 Annual Compliance Report (Dec. 29, 2014) at 38. *See also* Responses of the United States Postal Service to Questions 1-6, 8, 10, 12-13 and 15-22 of Chairman's Information Request No. 2 (Jan. 23, 2015) at 6.
[14] Initial Comments of PHI Acquisitions, Inc., Docket No. ACR2014 (Feb. 2, 2015) at 2.

Valpak asserts that the market-dominant program is a failure. In comparison, Discover expects the pending NSA will "create economic incentives . . . to increase [its] use of mail . . . [and that the NSA will] maintain mail's position among Discover's targeted marketing channels, increase gross revenue, and increase incremental contribution".[15]

The Postal Service does not believe the market-dominant program is a failure. Rather, it represents a promising source of future revenues and a means to slow the loss of volume among Market Dominant products. As Mr. Talwar stated,

> ". . . but for this NSA, [Discover] would be moving more dollars out of mail and into . . . digital channels next year and the years after, and the Postal Service would be losing revenue and without [Discover's] previous NSA, this decline would have been greater. With this NSA, the Postal Service can retain the profit from [Discover's] growth of the last several years, and add modest new growth".[16]

III. Costing

A. UPS identifies no valid basis to question the compliance of Competitive Products with the applicable standards

In its Comments, UPS first alleges a number of potential deficiencies in the Postal Service's costing systems, then acknowledges that resolution of these matters is beyond the scope of this proceeding, but ultimately announces an intent to seek to initiate a separate proceeding to address them. UPS is certainly correct that resolution of such matters is well beyond the scope of the ACR review process. But more fundamentally, the allegations presented of purported shortcomings in postal costing do not withstand scrutiny. Contrary to what UPS suggests, postal costing systems are

[15] Talwar Statement at 2.
[16] Id. at 4-5.

working as intended, even in the context of changing operations and some degree of shifting focus.

Moreover, throughout its comments, UPS speaks as if it were the Postal Service alone who classifies costs as attributable or institutional. For example, the section heading on page 10 asserts that “the Postal Service is significantly overstating its institutional costs.” Yet in preparing the cost information supplied with the ACR each year, the Postal Service is only applying the costing methodologies approved by the Commission. Those methodologies, in turn, are not focused on any particular global level of attributable costs or institutional costs. Instead, they operate to evaluate costs at a much more granular level, and seek to achieve the correct costing result for each discrete cost component evaluated. General complaints about the overall level of attribution, as UPS offers on pages 2-3 and 10-11 of its Comments, shed no light on the legitimacy of the actual costing methodologies employed. As the Commission implied in last year’s ACD when rejecting similar complaints by UPS, allegations about overall attribution levels, rather than suggestions to improve specific current procedures, do not merit consideration. *See*, FY2013 ACD (March 27, 2014) at 95.

UPS is equally off base when asserting that there is “no evidence” that the Postal Service is moving to improve cost attribution. UPS Comments at 5. In reality, the Postal Service recently filed the results of a major effort to improve city carrier cost attribution, designated as Proposal 13 and submitted on December 11, 2014. *See* Order No 2294 (Docket No. RM2015-7, Dec. 18, 2014). Among the factors that motivated that study were changes in mail volumes, including changes in the share of total volume (and hence carrier workload) that packages represent. Other proposals, while perhaps less monumental than the city carrier research, have also been advanced by the Postal Service. For example, Proposal 11, filed on November 4, 2014 and very recently approved by the Commission in Order No. 2350 (Feb.9, 2015), increased the attribution level of credit and debit card fee payments from approximately 42 percent to close to 100 percent, thereby decreasing institutional costs by over $100 million. Order No. 2350 at 3-4. UPS utterly ignores these developments when making a blanket statement purporting to see “no evidence” of progress.

UPS does make more specific complaints about changes the Postal Service has made to improve its ability to handle parcels. UPS Comments at 5-10. UPS argues that the Postal Service should provide clear and transparent accounting for large expenditures tied to competitive products, and ensure that an appropriate share of such costs is distributed to competitive products. *Id.* UPS claims that even within the non-public materials to which its consultants have gotten access, the data are “incomplete.” Thus, according to UPS, even where data relating to a new investment are reported:

> … it is nearly impossible to identify and evaluate (i) the accuracy of the “distribution keys” used to assign costs to products, (ii) the methodologies employed to develop these distribution keys, or (iii) the underlying cost pools to which these keys apply. This lack of clarity is especially great for newly created equipment cost pools that do not fit neatly into previously defined cost categories.
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> These gaps in the data make it effectively impossible to understand how the Postal Service is treating large expenditures relating to competitive products. Without more transparency regarding these issues, neither the Commission nor the public can have confidence in any compliance determination regarding competitive products.

Id. at 8

UPS gives very specific examples of the types of investments upon which it claims greater transparency is required. One example was DSS/PASS:

> In FY 2014, the Postal Service made large investments in Delivery Scanning Systems (DSS) and Passive Adaptive Scanning Systems (PASS). "DSS allows offices and other delivery units to efficiently capture arrival at unit scans on packages, and it tells the operator which route the package belongs on" and "improves our ability to provide efficient and timely delivery for packages that have just arrived in unit from large eRetailers." USPS Report to Congress, 56 (2014). PASS "serves a similar purpose as DSS," only for "larger postal facilities." *Id.* The Postal Service purchased and deployed over 12,500 Delivery Scanning Systems and over 2,700 Passive Adaptive Scanning Systems in FY 2014. *Id.*

UPS Comments at 5.

Indeed, as UPS asserts, the Postal Service made large investments in the DSS and PASS systems. Consequently, as plainly explained on the first page of the Preface to public folder USPS-FY14-8, a new equipment category for these systems was created:

> This fiscal year, a new equipment category PASS/DSS (or Passive Adaptive Scanning System/Delivery Sortation System), was added. This equipment is used in processing work at the delivery units to scan and sort parcels, Express Mail and Priority Mail. As for other equipment, the costs for this equipment takes on the variability of the labor costs of those that operate the equipment. The distribution key for category is the RPW parcel volumes, with the exception that for Express Mail and Priority Mail, volumes for all shapes are included.

The Preface to USPS FY14-25 similarly notes:

> For this fiscal year, the workbook MPPGBY14PRC.XLS was adjusted to accommodate the new equipment category PASS/DSS (or Passive Adaptive Scanning System/Delivery Sortation System), which is described in USPS-FY14-8. The depreciation, maintenance labor and parts/supplies costs for this new category was incorporated into the piggyback factor costs for the delivery unit processing cost pools where this new equipment is used.

In that regard, however, note that because these systems are new and the initial installation and purchasing would be included in the Capital Investment, costs for maintenance labor and supplies have yet to be seen. In turn, USPS FY14-7, Part VI details the calculation of the Mail Processing Variability used throughout USPS FY14-25, including that for the DSS and PASS systems. And, as noted on page 2 of the Preface to USPS-FY14-8, the calculation of the actual distribution factors for PASS/DSS is obtained from USPS-FY14-NP25.

Consequently, the treatment of the DSS/PASS systems in the ACR achieves exactly the result which UPS is arguing should be achieved. The Preface for the CRA Model (USPS-FY14-31) explains the details:

> 4. A new equipment distribution key (component 977) was added for PASS/DSS to 98.2. See USPS-FY14-7 for a description of the development of this DK.
> 5. This DK will have the Manual Parcel Sorting (MANP) cost pool variability and a distribution key based on RPW parcel volumes and be printed in F Report
> 6. An Equipment Maintenance Labor factor (1234) was added in 98.8 for PASS/DSS and distributed in A Module using routine "DA" and distribution key 977.
> 7. A new Equipment Parts and Supplies factor (1264) was added in 98.9 for PASS/DSS, distributed in A Module using routine "DA" and distribution key 977.

The pieces fit together as follows. As shown in tab Page IV-4 of the fy14equip.xls file of USPS-FY14-8, total FY14 equipment depreciation expense was $785 million, of which PASS/DSS constituted $15.316 million. (As shown in cell E13 on tab PageIV-9, PASS/DSS depreciation expense was thus 1.951 percent of the total.) The distribution information for PASS/DSS is shown in USPS-FY14- 31, under the Reports folder, in file FY14.FRpt.xls. Tab CS98.2 contains the variabilities and distribution factors for equipment depreciation. The variability for the PASS/DSS key appears in row 5 at 95.9 percent. Column E shows the distribution factors for PASS/DSS for each product. These are effectively percentages, with total attributable shares adding up to 100 percent. As shown in cell E57, 83.6 percent of PASS/DSS attributable depreciation costs have been distributed to Competitive Products. (That 83.6 percent is further distributed to individual Competitive Products in the nonpublic materials, also in accordance with the data obtained from USPS-FY14-NP25, but that disaggregation is not germane to this discussion of the overall effect on Competitive Products.). Thus, in accordance with what UPS argues *should* be occurring, the vast majority of the PASS/DSS depreciations costs *are* being added to the costs of *Competitive Products*.

Note that virtually all of the materials cited above are *public* materials, to which anyone interested has direct access on the Commission's webpage. The claim by UPS that "[w]ithout more transparency regarding these issues, neither the Commission nor the public can have confidence in any compliance determination regarding competitive products" is directly contradicted by the facts as presented above. The transparency that UPS seeks already exists.

Beyond DSS/PASS, UPS also mentions MDD:

> The Postal Service also began purchasing hundreds of thousands of Mobile Delivery Devices (MDD) in FY 2014. "The MDD is the latest generation handheld device used by delivery carriers to record near real-time delivery tracking of packages." USPS Report to Congress, 56 (2014). After a lengthy selection process, the Postal Service signed a purchase contract with Honeywell for a maximum value of $250 million for up to 225,000 scanners.5 These purchases continue: since September 2014, the Postal Service has deployed approximately 5,500 MDDs per week, and expects full deployment by September 2015. USPS Report to Congress, 56 (2014). The Postal Service had to spend $1 billion to upgrade its IT infrastructure to handle the increased load the MDD's would create.

UPS Comments at 5-6 (footnotes omitted).[17] The deployment of the MDD had hardly begun as the fiscal year was coming to a close. Consequently, not even a full month's

[17] The Postal Service, however, does not agree with the UPS assertion that the Postal Service "had to spend $1 billion to upgrade its IT infrastructure to handle the increased load the MDD's would create." Without attempting to delve into the exact source of the misunderstanding, the comment by CIO

depreciation had occurred for the MDDs. When depreciation of these items begins, the Postal Service will include these devices in the calculation of equipment expenses. The calculations will be supported by the same type of documentation in the ACR folders discussed above. Additionally, the Postal Service will be further investigating the cost impact of the IT upgrades required for these devices.

The UPS Comments also address Sunday delivery of packages. For example, with respect to such deliveries specifically around the holidays, UPS notes that "[d]uring the peak 2014 holiday season, more than 20 million packages were delivered on the five Sundays prior to Christmas." UPS Comments at 5. Although these particular deliveries in the first quarter of fiscal 2015 fall outside the scope of the FY 2014 ACR, the Postal Service in previous fiscal years has used Sunday package delivery during the peak holiday season to manage workload and ensure service performance. The standard costing procedures, however, take account of the fact that these holiday Sunday deliveries are primarily packages, and contrary to what UPS implies at page 9, they are not "reflexively … treated the same for costing purposes as routes involving delivery of both mail and parcels."

Concerns that UPS raises with respect to the NSA Sunday deliveries (UPS Comments at 5) are also groundless. Specifically to counter the type of concern that UPS identifies, the methodology used to arrive at the Sunday/Holiday delivery cost for NSA packages assumes that 100 percent of the costs are attributable to the packages delivered. Those procedures, the details of which are presented in USPS-FY14-NP27,

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Cochrane interpreted by UPS to that effect was actually a broader statement, and was never intended to suggest that the amount of $1 billion was specifically the amount the Postal Service had to spend "to upgrade its IT infrastructure to handle the increased load the MDD's would create."

carefully calculate the complete range of Sunday costs incurred, and then actually conclude with a final adjustment that pulls costs that would otherwise be reported as institutional and shifts them to NSA costs. While the details of the calculations are provided under seal, the Commission has ample opportunity to confirm that the costs of Sunday delivery are properly allocated to the appropriate NSA product.

To its credit, UPS acknowledges that the ACR docket is not the appropriate forum to attempt to resolve the concerns it has raised. To some extent, because of that recognition, no further reply may be necessary at this time. Yet the Postal Service does not want to stop there, and potentially leave the impression that it would be a beneficial expenditure of regulatory resources to address those concerns in some subsequent proceeding. Rather, in the view of the Postal Service, the concerns UPS has expressed are not well founded. Costing of competitive products is adequately handled by the existing costing procedures, and thoroughly reviewed by the Commission.

B. Claims regarding underwater products do not withstand scrutiny

As in previous ACR proceedings, commenters focus a great deal of attention on underwater products, notably Standard Mail Flats ("Flats").[18] In particular, Valpak's comments present what it characterizes as "economic fundamentals for increasing contribution **within a rate cap**"[19]. Valpak again recommends rapid price increases on underwater products to eliminate negative contribution, irrespective of considerations of demand elasticity, and asserts that it is "self-evident" that the Postal Service could

[18] See, for example, the comments of Valpak, PostCom, the Utah Hispanic Chamber of Commerce, American Catalog Mailers Association, and the Public Representative. Since Valpak's comments constitute the majority of the commentary concerning Standard Mail Flats, and underwater products generally, the Postal Service largely focuses its responses in this section on Valpak's arguments.
[19] Valpak Comments, at IV-11.

"readily increase its contribution" by doing so.[20] Consequently, Valpak recommends that the Commission issue a new remedial order on Standard Mail Flats pricing and take action to prevent the Postal Service from underpricing underwater products.

However, Valpak's analysis again fails to correctly consider the interplay of the price cap and demand trends for underwater products. The unique strictures of the cap render it unlikely that Valpak's preferred course of action will materially benefit the Postal Service's overall finances. In particular, Valpak's recommendation that price increases should vary inversely with cost coverage[21] does not withstand scrutiny. Fundamentally, contribution-maximizing pricing depends in theory on: 1) demand elasticities; and 2) that low-elasticity products receive relatively high markups. Without consideration of the demand elasticities specific to underwater products, especially in relation to other products, Valpak cannot proclaim that rapid price increases on underwater products will necessarily improve the Postal Service's finances.

In Docket No. ACR2012, the Postal Service directly addressed the claim that rapid price increases for underwater products in the context of the cap would "self-evidently" improve the Service's finances. In fact, as was demonstrated in the scenario analysis presented in USPS-FY12-43, the net impact on Postal Service contribution from raising prices on underwater products is ambiguous, at best.[22] First, the scenario analysis shows that any improvement in contribution for underwater products is partly offset by the impairment of contribution from above-water products that would necessarily see declines in inflation-adjusted (if not nominal) prices. Second, and importantly, the scenario analysis shows that non-transient declines in demand lead to

[20] *Id*. at IV-12.
[21] *Id*. at IV-15 to IV-17.
[22] Docket No. ACR2012, USPS-FY12-43, Scenario Analysis for Standard Mail Contribution, at 2.

permanent loss of pricing authority under the cap. The latter effect can dominate under realistic conditions,[23] such that rate increases on underwater products with declining demand can substantially reduce total contribution over time.

That Valpak continues to neglect these dynamic considerations is consistent with the limitations of its "Contribution Maximizing Model," which was addressed by the Postal Service's reply comments in Docket No. ACR2013.[24] Valpak's model, which Valpak again recommends that the Commission consider as a pricing guide (though the model has not apparently been revised or resubmitted) did not incorporate critical features, such as the interplay between the price cap and longer-range demand dynamics, needed to properly assess the implications of alternative pricing paths.

With respect to Standard Mail Flats, Valpak devotes considerable attention to the increase in FY 2014 measured costs for Flats. Valpak asserts that this increase is evidence that the current remedial actions are insufficient.[25] However, as noted by the Postal Service in its response to ChIR No. 3, question 3, and in USPS-FY14-45, mail marking issues related to the implementation of FSS Scheme preparation rules are believed to have led to some over-attribution of costs to the Flats product. Accounting for the estimated impacts on mail processing and City Carrier in-office costs as presented in Table 5 of USPS-FY14-45, the FY 2014 Flats cost coverage would be approximately 83.1 percent, which explains 1.5 percentage points of the decline in Flats cost coverage cited in Valpak's Table IV-2.[26] Thus, while cost coverage did decline

[23] These conditions include demand declines of the magnitude actually experienced for Flats, 100 percent variability of attributable costs with volumes, and demand elasticities within a reasonable range of the Postal Service's published estimates.
[24] Docket No. ACR2013, Reply Comments of the United States Postal Service (Feb. 14, 2014), at 4-5.
[25] Valpak Comments, at III-14.
[26] The Postal Service's proposed FSS Scheme pricing in Docket No. R2015-4 would, in principle, address the underlying cost attribution problem.

relative to FY 2013, even after the adjustment in USPS-FY14-45, the adjusted coverage remains higher than the FY 2010 and FY 2012 coverages cited by Valpak at pages II-7 and IV-2 of its comments. Moreover, in its response to ChIR No. 3, Q3, the Postal Service also offered a variety of explanations, including transitional complications associated with the implementation of FSS Scheme preparation,[27] that militate against using the FY 2014 cost increases as an indictment of the Postal Service's remedial efforts to reduce Flats costs.

While it is unsurprising that a mailer of High Density/Saturation Letters would focus its comments on improving Standard Mail Flats' cost coverage, Valpak's arguments noticeably ignore the 3.6 percentage point increase in Flats cost coverage achieved since the FY 2011 ACD. This omission is rather notable given that the Commission's 2010 ACD Order directed the Postal Service to "increase the cost coverage of the Standard Mail Flats product through above-average price adjustments...and cost reductions."[28] As evidenced by: 1) the implementation of two above average price increases for Flats in Docket Nos. R2013-1[29] and R2013-10;[30] 2) the proposal of a third above average price increase in Docket No. R2015-4;[31] 3) the proposal, in Docket No. R2015-4, of a new FSS price structure designed to encourage more flats mail being prepared for FSS processing; 4) the improvement in Flats' cost

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[27] As noted in the ChIR 3 response, the FSS Scheme implementation appears to have had some transitional adverse cost effects resulting from operational and mailer compliance difficulties.
[28] Docket No. ACR2010, Annual Compliance Determination Report: Fiscal Year 2010 (Mar. 29, 2011), at 106.
[29] Docket No. R2013-1, Order No. 1573: Order on Standard Mail Rate Adjustments and Related Classification Changes (Dec. 11, 2012), at 4.
[30] Docket No. R2013-10, Order No. 1904: Order Approving Amendments to Market dominant Price Adjustments (Dec. 11, 2013), at 4.
[31] Docket No. R2015-4, United States Postal Service Notice of Market-Dominant Price Adjustment (Jan. 15, 2015), at 21, Table 7.

coverage since FY 2011;[32] 5) the ongoing operational efforts to reduce flats costs;[33] and 6) the Postal Service's commitment to continue implementing the schedule of above-average price increases approved by the Commission in the FY 2013 ACD,[34] the Postal Service believes that it is in full compliance with the Commission's orders and directives.

While the Postal Service shares Valpak's goal of achieving 100 percent cost coverage for all underwater products, Valpak's preferred remedy of large and rapid price increases does not provide a superior alternative to the Commission's current approach, and is not guaranteed to improve the Postal Service's overall finances. Accordingly, based on the above, the Commission should decline to implement any additional orders with regard to pricing for Standard Mail Flats or other underwater products.

C. ACMA claims regarding Standard Mail costs are likewise not well-founded

In Sections II through V of its Comments (pages 5-20), ACMA makes a number of arguments attempting to call into question the reported costs for Standard Flats. In general, the Postal Service views these arguments to be without merit. Rather than attempt to address every argument made, however, the Postal Service will focus its reply on allegations made by ACMA with respect to carrier costs. There is no reason to believe, however, that the other portions of Sections II through V of the ACMA Comments are not equally flawed.

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[32] See United States Postal Service FY 2013 Annual Compliance Report (Dec. 27, 2013), at 19-20.
[33] See, for example, pages 4-12 of Attachment A to the Supplemental Information Provided in Response to Order No. 2313 (January 15, 2015).
[34] Docket No. ACR2012, Annual Compliance Determination Report for Fiscal Year 2012 (Revised, May 7, 2013), at 115-116

The analysis of city carrier street time costs presented in the ACMA Initial Comments betrays a fundamental misunderstanding of how city carrier street time works. That misunderstanding is apparently the source of at least two fatal flaws in the analysis.

For example, the description of street time operations presented on page 13 of the ACMA Comments is clearly erroneous. The ACMA Comments states that adding another piece of mail to a carrier's route should not add any time during the physical delivery of mail into the receptacle as "the need to fold pieces together and insert into the box would not change." In contrast to this unfounded assertion, numerous previous studies, including those done by the Commission, have demonstrated that the time it takes to load mail into the receptacle is, in fact, volume related. Additional loading time could arise in a variety of ways. An additional piece could be arriving at a delivery point that was not otherwise receiving any mail on that day and, as a result, creates additional loading time. Or, the additional piece could cause the carrier to combine mail from an additional bundle that otherwise would not have been handled, adding to the time required for combining the mail before insertion into the receptacle. While there is not a proportional relationship between volume and loading time, contrary to ACMA's assertion, as volume rises or falls, so does loading time.

This type of misconception infects ACMA's discussion of marginal delivery time and helps explain why it appears to be unable to understand why a decline in volume could cause delivery time per piece to rise. This is highlighted by the first fatal flaw in ACMA's analysis. ACMA argues that variations in marginal delivery time <u>could</u> arise because of economies of scale, but there have been no scale change in the Postal

Service's delivery network, so marginal times should remain constant as volume declines.[35] But a fundamental tenant of network economies is that the variations in marginal times arise not because of economies of scale, but because of economies of density. A well know characteristic of the Postal Service's delivery network, like other types of networks, is that as additional volume is delivered to a fixed number of delivery points, the delivery time per piece decreases. Conversely, as the amount of volume delivered to a fixed number of delivery points falls, the associated delivery time per piece increases. Clearly, it does not take twice as long to place two pieces in a mail receptacle as it does to insert a single piece. The resulting per-piece delivery time savings is a result of economies of density. When volume falls, the loss of density economies means that delivery time will fall less slowly than volume. Amazingly, the ACMA Comments completely ignore this fundamental characteristic of the Postal Service's delivery network, and thus misses the fundamental reason that delivery time per piece increases as volume falls.

The other fatal flaw in ACMA's analysis is that is apparently oblivious to the fact that while delivered volumes have been falling, the Postal Service's network of delivery points has been increasing. From FY 2007 to FY2013, the Postal Service had to serve and additional 1.8 million city carrier residential delivery points. The distribution of a smaller volume of mail across more delivery points necessarily increases the delivery time per piece as that volume is delivered across a more extensive network.

In sum, declining delivered volumes and rising delivery points, both which the Postal Service has experienced in recent years, necessarily lead to increases in

[35] For example, on page 17, the ACMA Comments states, "We believe that an understanding of carrier operations would suggest that marginal costs should be relatively constant over a wide range of volume."

delivery times per piece. That such increases may have been occurring should not come as a surprise and ACMA's apparent inability to understand the source of such increases is simply a reflection of its unfamiliarity with the nature of city delivery.

IV. The Postal Service Works to Improve Service Performance

The Public Representative discusses Service Performance on pages 3 to 20 of her comments. The major questions the Public Representative poses are why the Postal Service's past efforts to increase service performance have not resulted in improvement, why the Postal Service's scores this year were worse than last year in many regards, and what initiatives the Postal Service is working on to improve service performance for FY 2015.

With respect to the Public Representative's comments regarding service performance, past efforts to increase service performance have been met with inconsistent results. In many cases our service performance in FY 2014 was virtually flat compared to FY 2013, with some products experiencing declines. As the Postal Service continues to evolve in the current economy, it expects to have both successes and failures. Only by advancing successes and learning from failures can the Postal Service continue to provide members of the public with the services they require. Furthermore, the Postal Service struggled some with capacity issues in our 3-5 day network due to unparalleled growth in package processing. As previously cited, poor service performance can be attributed in large part to the impacts of several winter storms. During Quarters 1 and 2 in Fiscal Year 2014, there were 24 major storms which caused the Postal Service to experience major transportation interruptions and delays in the processing and delivery of mail. Despite the heroic efforts of our employees, the after-effects of these storms had negative impacts on our service performance. The Postal Service did, however, show improvement in Quarters 3 and 4. Looking forward, the Postal Service will monitor performance indicators, identify the vital few, and deploy service teams to correct identified issues. In FY 2015, the Postal Service will incorporate lean mail processing strategies to standardize our processes to ensure that mail flows continuously and review our transportation to consider more point to point service. Focus on specific products will allow the Postal Service track the performance of the product on its own so that its performance can be improved.

The Postal Service expects that service performance scores will increase in FY15 as a result of the measures the Postal Service is undertaking across its network as the Postal Service continues to adapt to market changes.

V. Conclusion

The Postal Service appreciates the opportunity to comment on the issues raised by the parties in their initial comments.

Respectfully submitted,

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